Dear Reader,

Welcome to the first instalment of our 2010 Cross-Sector Risk Research programme. This report raises a critical subject for corporate Britain that has so far received scant attention. Mactavish is pleased to kick-start what we believe is an essential debate within the wider framework of corporate governance.

In this programme we set out to analyse changes to the risks facing UK companies, and how they manage them, arising from the worst recession in a generation. What we found was a scale and scope of practical change far beyond our expectations - changes which drive a clear increase in risk. At the same time, neither company management nor insurers included in the study were fully plugged into these developments or yet ready to address them. This suggests that volatile and unpredictable outcomes are inevitable. We have looked at companies across many key sectors including manufacturing, retail, construction and financial services.

In many respects new and increased risk is a natural consequence of companies adjusting lastingly to tougher conditions. However, this emerging reality clearly turns up the heat on flaws within the existing system for explaining, managing and transferring risk. In today's challenging capital raising climate, UK businesses rely on insurance more than ever to support their operations yet it remains routinely underestimated and under-scrutinised as a corporate function.

We know for certain that increased risk carries increased cost when things go wrong. What is much less sure, given today's lack of focus on the explanation of risk, is how quickly this cost will increase and how it will be divided between shareholders of companies themselves and the insurance industry. In a higher risk and lower margin environment, Mactavish suggest that both parties would be very well advised to take a closer look at this question.

We hope that you find the research interesting, even if the findings are sometimes concerning.

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Mactavish

Mactavish Sector Risk Research 2010 – Stage One

Cross-Sector Findings Summary

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1. Executive Summary

1.1 Introduction

A global recession of unprecedented and ongoing severity has gripped the UK and world economies over the past two years. During this time companies have been forced to respond to rapid and overwhelming changes in trading conditions – and this has caused a systemic seismic shift in the corporate risk landscape. Mactavish has undertaken a major programme of research in 2009 to analyse the sectors of the UK economy most affected by the downturn. The main focus of this study was to understand how corporate risk exposures have changed and how this impacts the demand for, and supply of, insurance capital.

Mactavish is a research firm specialising in commercial risk and insurance. In particular, this study's interest lies in analysing changes to high-severity risk: exposures where a major loss could threaten the viability of even large businesses and carry a material level of cost to insurers. In addition, we are also interested in systemic developments in higher frequency loss types where the aggregate impact is also material.

1.2 Methodology

The study to date has comprised in-depth consultations with operational and financial management in c.250 large and mid-size UK companies (defined as broadly above £50m in turnover, of whom this sample represents over 7.5%) across the target sectors. It has also included c.40 consultations with senior underwriters driving insurer policy in relation to these sectors, across all critical risk categories. The research programme will continue to broaden sector scope further in the coming months, but initially focuses on four UK sectors: Independent Manufacturing, Construction, Retail and Financial Services.

1.3 Summary of findings

The core argument put forward in this paper is that **operating risk in the sectors under investigation is changing to an unprecedented degree as a result of prevailing economic conditions over the past 18 months.** This change arises, beyond the headlines on bailouts or company failures, from multiple practical, operational-level changes across corporate Britain. The finding is not that operational change is new or particularly noteworthy in or of itself. Instead, it is the magnitude, speed and concurrence of the changes implemented by a majority of companies which are unprecedented in their scale and reach. These changes, when added together, have a material impact on a number of high severity risk types – as evidenced by the full report.

Examples of such changes are diverse and include: systemic supply chain disruption caused by company failures and a plethora of efficiency measures throughout the trading system reducing resilience and increasing product quality risks; increased rates of product and activity diversification; direct risk impacts of cost cutting measures and headcount reductions; drastically increased contractual liability pressures arising from strained commercial renegotiations; the impacts of expanded low-cost outsourcing; regulatory changes and the emergence of new or more material risk exposures - from the relatively obvious (building site mothballing or counterparty credit risk) to the somewhat esoteric (financial services fraud, mis-selling, mandate breach or cyber crime). Necessarily sector-specific, we consider each of these and more in the full report below.

We argue that on balance, within these sectors, **the impact has been to increase the level of underlying risk**. Companies are under great economic strain and focused on adjusting to a drastically changed environment. The network of corporate risks is far more systemic than was the case even 5-10 years ago as companies operate in an ever more complicated and interconnected value chain. Further, far more of the operating changes discussed in this research programme increase the scale and complexity of risk rather than decrease it. Not only are the risks faced by firms getting greater and more complex, companies are ultimately more reliant on insurance given that few have the luxury of significant cash reserves and access to new debt remains constrained.

Whilst focused on revenue protection and cost reduction measures to adjust to economic conditions, **companies are not yet focused on either responding to or communicating changes to key risk exposures, putting insurance coverage at risk**. 65% of corporate respondents consulted do not even review the information used to place insurance risk for completeness or accuracy. This is concerning given that such information comprises a *de facto* part of the insurance contract on which their business relies. While insurance capital remains relatively cheap its importance to companies' financial mix goes largely unrecognised and most insurance buyers are not incentivised to prioritise more highly.

As a result of such changes, actuarial and underwriting assessment models based on past experience are less reliable than at any time in recent history. This is true since future losses are more likely to diverge from the past in terms of types of claim, frequency and severity. While insurers and reinsurers traditionally deal in slowly evolving risk patterns and apply great analytical power to extrapolating historic loss trends, such discontinuous changes as those brought on by the economic downturn require company-specific risks to be studied in depth. This will necessitate changes to the traditional approach to insurance procurement.

We reflect on a significant body of evidence which suggests that **case by case risk disclosure standards are not improving to compensate for increased change, and in many cases are becoming less satisfactory.** This view comes from underwriters' assessment of poor (and worsening) information received to judge risks and the lack of relevant access to corporate management. In reality, most underwriters we consulted take the view that in the absence of satisfactory disclosure information they must suffice with a combination of worst-case assumptions and waiting for exposure changes to eventually filter through into loss patterns over the next 2-3 years.

1.4 Critical implications - buyers

A strong theme emerging from the research is the willingness on the part of corporate guardians of risk to take credit for the

sustained period of benign insurance pricing. Short memories – and changes to personnel – appear to have dimmed recollections of the drastic changes in the price and availability of risk transfer in the hard market of 2002-04. While notable exceptions exist, companies have adapted to favourable insurance market conditions by prioritising other objectives above insurance risk.

Most are only very slowly coming around to realising the significance of the challenge raised by the far-reaching changes to risk profiles now being seen. The implications of waiting for loss patterns to materially change *before* extensively re-communicating risk will a) increase scope for claims disputes and the risk of major delays in the payment of claims and b) ensure underwriters are surprised by the loss trends emerging leading to a far more severe and less precisely targeted underwriting response in terms of price and capacity.

The importance of this point cannot be over-stressed: the total cost of risk to companies will drastically increase if action is not taken to reassess and communicate risks in light of the changes to the risk landscape. This will manifest itself through increased insurance spend, additional uninsured loss costs and greater risk of claims disputes arising from material misunderstanding of risk & coverage. To come to this view we have drawn on a range of practical real evidence, underwriting views on how assumptions have to be made in the absence of information and parallels with the last insurance hard market.

As a result, we draw three critical, related buyer conclusions:

- **Significant combinations of strategic and operational change, both within individual companies and across multiple companies within a single supply chain, have introduced material new risks to earnings for many companies**
- **Inadequate disclosure by buyers and their brokers is likely to mean that less of these new risks are properly insured, leaving shareholders carrying the risk of loss**
- **Spurning the short-term opportunity to prepare by improving disclosure whilst market conditions remain favourable creates avoidable volatility, and will increase the cost of risk for all buyers in the long-term**

If they wish to avoid encouraging this outcome, there needs to be a step-change in the mindset of buyers and the senior operational management that ultimately control risk. They must more strongly recognise the importance and financial value of insurance capital, and re-assess the adequacy of disclosure which underpins it.

1.5 Critical implications – insurance suppliers

Our in-depth review of these research findings with underwriting policy-setters leads to an important conclusion. Underwriters, for the most part, lack the detail necessary to critically assess the impacts of new and shifting corporate risk exposures. Instead, the dominant response has been somewhat concerned recognition of material changes and a resignation to await changes to loss patterns before being able to structure a response.

Underwriting remains in large part driven by historic-looking actuarial models and a portfolio-based approach. Despite its sophistication, such an approach is not well-suited to dealing with rapid, discontinuous change – like that now being experienced across corporate Britain. Nor has the raft of underwriting innovations in recent years focused on obtaining rich detail about specific company risks. Rather, it has predominantly sought to build a modelling structure that enables underwriters to appraise risks in a consistent manner given the limitations of the information available to them.

This is not a criticism of underwriting expertise, it is simply an observation that underwriters remain at arm's length from corporate operational management, which itself is often disengaged from insurance buying. When this is added to organisational frameworks typically divided into silos purely based on risk class it creates a potential problem in building forward-looking, deep sector knowledge. Systemic losses will need to emerge before changed and newly emerging risks can be built into underwriting decisions.

Based on both the risk findings set out above and underwriting views, the report reaches three key insurer conclusions:

- **Due to major current shifts in the risk landscape the reliability of historically-focused rating models is far lower than in the recent past.** Systemic under-pricing is inevitable through 2010 as underlying risk increases and rates suffer continued downward pressure. This introduces a new risk to the earnings of property & casualty insurers over the coming years
- **Some parallels can be drawn between large property & casualty insurance institutions today lacking the ability to fully understand changing risk exposures and more publicised past failures of financial institutions to understand risks assumed.** While loss impacts naturally lag economic changes by several years, turmoil in corporate insurance is expected as a latter phase of the financial crisis. Diversified insurance organisations that have withstood the crisis thus far are unlikely to fail as a result, but we expect significant changes to earnings patterns of those heavily exposed to business insurance risk to emerge until closer partnerships with their customer base can be constructed.
- **Once it finally arrives, a combination of the eventual hard market cycle together with significant changes to loss profiles already emerging suggests a potential 'perfect storm' of volatile corporate insurance market conditions over the next 2-3 years.** We would expect this to be reflected in significant loss ratio deterioration, harsh subsequent pricing increases, capacity limitations and damaging sector coverage 'blackspot' areas as insurer understanding plays catch-up.

Overall, as a research activity, the primary outcome of this study has been to set out an overall picture of a materially increased and changed risk landscape and a surprisingly limited level of readiness demonstrated thus far from all parties to respond to the challenge this represents.

As annual reinsurance treaty negotiations have recently completed moving into 2010, there seems to be scope for reinsurer concern based on this survey. If the corporate risk

landscape is changing as much as we have observed, reinsurers face a lack of proximity to significant exposure shifts across huge swathes of the economy. This leads to the real possibility of medium-term volatility before a) understanding catches up and b) traditional insurer portfolio management techniques can compensate for limited knowledge of company-specific changes. Certainly, a very close eye needs to be kept on loss trends as we move through 2010.

1.6 Ongoing research programme

This cross-sector paper is the first instalment of an ongoing programme of Mactavish research to be published during 2010. Subsequent pieces will analyse emerging individual sector issues more deeply, and revisit these cross-sector themes and associated underwriting policy later in the year to assess how both corporate experience and insurer policy play out. Following initial scoping interviews already completed, the study will also be extended into French and German markets in 2010.

2. Mactavish research overview

2.1 Background

Mactavish is a specialist research business focused on the risk and commercial insurance segment. We have been conducting cutting edge industrial research programmes across the UK, US and mainland Europe since the early 1990s, both independent programmes and in partnership with leading insurers, reinsurers, brokers and investment banks.

In particular, this 2010 sectoral risk study arose from the realisation that the impacts of economic upheaval unprecedented in the experience of a generation of corporate managers would be severe and lasting. Beyond the headlines, a plethora of nitty-gritty operational change is taking place, and Mactavish set out to investigate such changes and the consequences for risk and those who manage it. The findings have exceeded all expectations in both the materiality of such shifts to the risk landscape, and a widespread lack of readiness to address them.

During the final weeks of 2009 a number of supporting strands of comment have emerged to support the importance of this subject matter and increased scrutiny of corporate risk and the adequacy of its governance. Elements of note include the CBI's headline finding that business leaders increasingly expect the severity of this recession to change attitudes to corporate leadership and funding for a generation, forcing many companies to fundamentally rethink working models. Secondly, the long-term implications of November's Walker report on corporate governance and risk stewardship seem certain to extend beyond Financial Services, if only through impacted lending practices. Most direct of all, the Financial Reporting Council's proposed changes to the UK Corporate Governance Code specifically advocate significant risk management and risk reporting reform. This study aims to analyse the real operational detail underlying such concerns and to identify areas where risk is materially changing.

The Mactavish programme initially focused on four key UK sectors: independent manufacturing; construction; retail and financial services. This segment focus will be expanded further in the coming months. The approach was to consider for each sector:

- Systemic changes and challenges emerging across the sector value chain and the potential impact on various operating risks throughout the system
- Emerging corporate responses to such developments, whether operational, strategic or financial
- Associated developments in insurance capital and service requirements resulting from the above, and the extent to which such requirements have been/ are being met

As such, the investigation comprised three core workstreams:

- Consultations with ultimate corporate risk and insurance decision makers (whether Finance Director, Company Secretary, Legal Director, dedicated Risk Manager etc.)
- Follow-up analysis of key changes by consulting with senior operational management in each sector responsible for instituting key change measures
- Corresponding consultations with senior insurance underwriters assessing risk within the target sectors and setting policy.

2.2 Related previous research

In many respects, this sector programme was conceived as a follow-up to internationally focused Mactavish research published just prior to, and following the onset of, the last hard market, i.e. in 2000-01 and 2002-3. Several conclusions from those reports remain relevant today, and many of the headline themes re-emerged strongly in the current work. One critical area of comment we return to in detail below: concern raised at the implications of long-term risk disclosure weaknesses given doubts as to the effectiveness of much publicised industry efforts to address them in 2002-3:

> *"We question how widespread adoption of tighter underwriting discipline has been, and we especially question whether it will be enduring."* **Mactavish/ UBS Feb 2002**
>
> *"In our investigation to date, we have not been able to satisfactorily substantiate sellers' claims that underwriting rigour has improved. In fact, we have received considerable feedback to the contrary from numerous corporate customers and even a few insurers... buyers, in general, observed only limited changes in the sophistication of questions or in the structure of coverage following submission of additional documentation."* **Mactavish/ UBS March 2002**
>
> *"Carriers are demanding data where previously they glossed over it. But it is all superficial. They do not know what to do with the information. An underwriter admitted to me that the reports are just kept on file in case they are audited [by reinsurers]."* **Risk manager, manufacturing, £1bn-£5bn (2002)**
>
> *"I've been in the market for 18 years, and all we're seeing is a typical, cyclical increase in actuarial involvement but no step change. This happens every X number of years... a lot of [insurance] carriers have been signing up crap with no information at all."* **Head of reinsurance, mid-sized insurer (2002)**

Disclosure and underwriting rigour are clearly major themes of the current research, and it is interesting to note the enduring nature of what is a fundamental, non-cyclical, issue for the commercial insurance industry.

2.3 Programme Focus

The target of this research was independent UK headquartered firms in the turnover range £50m to £5bn: typically sophisticated and mostly international corporates facing complex risk profiles. This focus seeks to exclude both SMEs and the very largest multi-national UK headed

corporates (although at the top end this cut-off excludes only c.60 UK firms, of whom we have nonetheless interviewed a good sample). The key intention to assure valuable risk findings is to ensure a broad mix of complex operating risks and the financial materiality of insurance and risk transfer.

The four sectors noted above form the basis of the core cross-sector observations in this report, although the overall programme of Mactavish work will continue over the coming months to expand both deeper into these sector specifics and to incorporate additional sectors. Critically, the common theme amongst these four sectors is that major challenges have emerged to the operational status quo, and whether through immediate commercial necessity, regulatory changes or merely the expedient acceleration of existing initiatives, a large number of new impacts have hit over the course of 2009 with more to come in 2010.

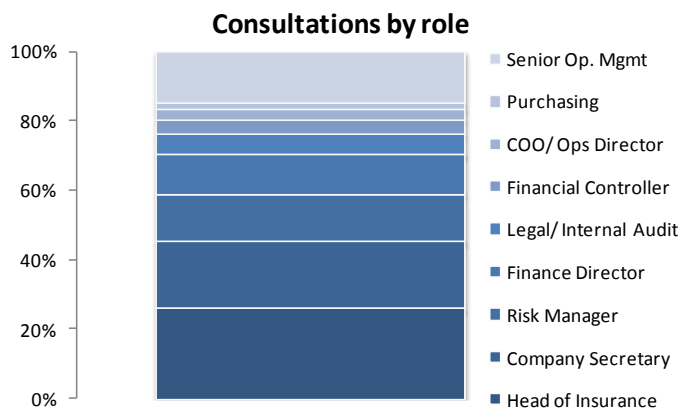
In total, this size bracket of company is responsible for a large share of private sector UK employment (c.36%) and GDP (c.41%)[1]. The scale of this survey was to undertake in-depth consultations with a large and representative sample (c.500 firms in total, or over 15% of the market), half in each of 2009 and 2010. At the time of publication of this first cross-sector paper, we have achieved the initial milestone, having conducted c.250 target sector consultations to date, with a further c.70 arranged for 2010.

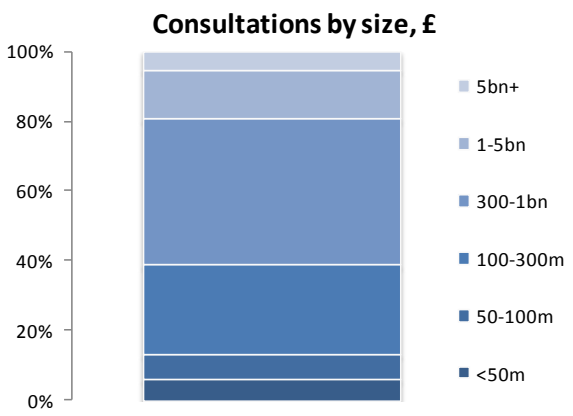
An overview of the size and role sample across the target sectors is shown below, reflecting our aim to consult with a range of relevant management personnel, a mix of company sizes and to analyse each point within the trading system of each sector under analysis.

From an insurer underwriting perspective, our focus was on the senior underwriters setting policy for the same buyers with whom we have concurrently consulted. The aim was to understand both the materiality of, and likely response to, the issues arising from the customer led research.

In total we have undertaken c.40 in-depth discussions probing the key findings of the buyer research and likely policy response with senior underwriters and underwriting policy setters across the UK corporate insurance market. The full 'line of business' mix spanned Property/ Business Interruption; Casualty (Public, Product and Employers' Liability); Financial Lines; Professional Indemnity (PI); Contractors All Risk and Motor, although was predominantly focused on high-severity, low frequency risk and systemic changes to attritional higher frequency losses. Whilst underwriting views, methods and strategy routinely differ and no study could argue to be an exhaustive reflection of a whole market consensus, Mactavish certainly believe the sample provides a reasonable and fair basis to draw some measured conclusions regarding likely underwriting conditions arising from the risk issues discussed.

Fig. 1 – Customer research programme breakdown





3. Background - the recession of 2008/2009

Since the violent consequences of the seizure of financial markets were first brought home in the UK by the run on Northern Rock in September 2007, at a UK and global level both financial and mainstream press have unsurprisingly been dominated by analysis and speculation regarding the ensuing economic downturn. It quickly became clear in 2008 that the optimistically termed 'credit crunch' was to have far more wide ranging economic consequences. The global slump we are likely to remain embroiled in for some time to come was unusual not only due to its sudden onset and severity (unprecedented for 70 years), but also its genuinely global nature, lastingly drastic impact on consumer and business confidence and prompting of a previously inconceivably dramatic policy response from industrialised governments.

Whilst people have increasingly come to terms with the global systemic nature of risks within the financial markets, we set out to explore whether or not a parallel global systemic set of risks was also now embedded in the corporate sector (such as manufacturing, construction and retail) due to the global reach of supply chains and global interconnectivity of operations. We also sought to assess whether or not those risks would be put under intense strain following companies' short and long term response to the financial crisis.

Taking just a UK perspective, we have seen not just the poisonous impacts of the freezing of financial markets seeping out across the economy, but also the overdue bursting of a debt driven consumption bubble together with a staggering loss of confidence trigger a severe contraction across most economic sectors. The initial contraction has been further compounded by a range of secondary 'knock-on' recessionary drivers, rapidly increasing unemployment and the ongoing fragility of the banking system limiting the impact of even extreme stimulus measures which themselves will take years for public funds to pay for. This is quite an array of powerful negatives at work together.

As conflicting signals about possible economic recovery emerged in late 2009, comment as to the timing and shape of a subsequent recovery remains varied as the recession in the UK also proves more enduring than across the rest of Europe. However, whilst the shape of recovery will depend on the ongoing interaction of the varied forces depicted above, as The Economist's outlook summary suggests "a gloomy U with a long, flat bottom of weak growth is the likeliest shape of the next few years" [2].

The bottom line is that total UK output has fallen by at least 6% in 18 months since early 2008[3], total UK GDP is predicted to settle at -4.5% for 2009[4], the largest drop since 1931. GDP forecasts for 2010 have improved over recent weeks but not much beyond +1%[5], unemployment is set to climb into double figures as a percentage of the workforce and total UK corporate insolvencies by mid 2009 had already outnumbered the full recessionary cycle of the early 1990s[6] with a higher annual total again expected in 2010[7]. At a global level, this is reflected in the first aggregate output decline since WW2, -1.5% in 2009[8]. And all this despite startlingly expensive rescue packages, the unprecedented launch of quantitative easing programmes and bailouts totalling well over $2tn globally aimed at propping up both banks and confidence. Whether UK recovery ultimately looks U or W shaped, it's highly unlikely to be either imminent or straightforward.

Rounding more firmly on the business world, while much press focus has been on high profile bailouts and a spiking SME business failure rate, Mactavish suggest that this headline view in fact drastically underestimates the aggregate significance of a raft of underlying change and systemic impacts which are felt throughout industry segments, as even amongst relatively robust larger corporates the survivors are forced to adjust for the long-term. Business in 2010 is far more interconnected, and specialised, than even 10 years ago and this increases the scope for financial and operational difficulties in one part of an industry to reach out across the value chain and even into apparently unrelated industry segments, fundamentally shifting the risk landscape as they go.

An obvious (but by no means new or unique) example of this phenomenon lies in the sudden contraction in availability of trade credit insurance wreaking havoc across entire trading systems. The volatility of this hidden form of working capital is newly exposed and financial professionals suddenly must address huge new liquidity requirements emerging against a risk that few even monitored previously (that of suppliers buying credit insurance against a company, which can be withdrawn without notice). Finance Directors may be suddenly forced to rapidly find hugely significant sums to ensure that suppliers continue to supply, when credit insurance against them, the existence of which they were likely unaware of, is suddenly withdrawn. Examples of such increasingly systemic phenomena come through strongly in each of the Mactavish sector papers.

Mactavish does not aim to undertake any exhaustive economic analysis, the like of which currently (and conflictingly) abound. The focus of this paper is on corporate risk, those who manage and finance it, and the significant threats to economic stability caused by the weaknesses in this system. As economic background it is sufficient to highlight the severity of recessionary pressures at work and the relative UK certainty of three key facts:

- Imminent, linear recovery is unlikely as of early 2010
- We will continue to see secondary impacts of these changes emerge for many years to come
- Operational responses to changed conditions are also likely to be both material and enduring.

4. Analysis of corporate operational & risk developments

In light of the above economic context, it is worth considering the importance of an altered industrial change dynamic from an insurance perspective. Corporate strategies and operational methods rarely stand still for long regardless of economic circumstances, and innovations will always mix success with failure. However, alterations to risk profiles tend to be relatively gradual and evolutionary, as losses begin to emerge from long term change. This supports an underwriting approach based around historical loss analysis and balancing portfolio exposures. Absent of systemic issues with reserving, localised issues with underwriting controls or atypical catastrophe behaviour, changing loss patterns drive a gradual underwriting response.

Further, a number of popular change themes discussed across the sectors covered in this research are clearly part of longer term trends where insurers are aware of some current and potential future loss impacts. Examples include low-cost country outsourcing or desired shifts towards a lower carbon economy. However, a central thesis of this report is that severe economic shocks have altered this gradual picture through a combination of noticeable effects:

- Prompting new operational responses
- Increasing the scale and pace with which existing measures are adopted
- Increasing the propensity for multiple change measures to be adopted concurrently, making likely a second round of innovation as some work whilst others do not.

The sections below summarise at a high level some such changes for our first tranche of sectors investigated, and subsequent individual sector reports will expand each in greater operational detail. Where these developments are more wide ranging and sudden, the impact on risk (and subsequent loss patterns) is likely to be similarly shifted away from the gradual emergence pattern. The key challenge is for insurers to cope with this shift as it happens without being forced into a reactive, after the fact punitive underwriting and claims disputing response once unexpected losses begin to emerge as escalating claims cost. We contend that this challenge shines the spotlight principally upon the day to day disclosure and underwriting process, requiring understanding to be built at the point of policy underwriting (rather than the point of claim) regarding the ultimate risk impact of such new operational change. Thus the burden on risk disclosure increases in the current climate, as do the consequences of any limitations to the traditional risk assessment model.

First, however, it is necessary to flesh out what we mean by the increased change found within the research. The following case studies provide an introduction of these findings by sector, and provide evidence of the materiality involved. In each case, a subsequent sector specific report will be published later in 2010, expanding upon specific risk observations and considering the emerging insurance industry response.

4.1 Sector research case study highlights

4.1.1 Sector One – Independent Manufacturing

Sector definition comprised (broadly within the £50m to £5bn turnover bracket) independently owned and British domiciled manufacturing firms, across a wide range of product segments. We largely sought to exclude those subsidiaries of overseas owned multinationals where the UK entity's risks may have been predominantly managed by the parent.

Headline examples of prevalent and material operational changes include the following:

1. **Increased speed and scale of low cost outsourcing trend and/ or overseas Joint Ventures**, drastically impacting the need to identify and manage new supply chain and product quality risks

By no means a new trend, but raised by around half of all manufacturing respondents as a current project with many choosing the recession as the right time to either finally take the plunge towards overseas manufacturing, or to scale up existing plans to realise much needed financial benefits faster. Findings suggest a current surge in outsourcing increasingly including design & support activities previously considered a core activity and maintained in the UK.

Respondents split between those who have undertaken a long term, multi-year scoping exercise to identify, select and build relationships with overseas partners, taking time to gradually transfer expertise, tooling and management capacity, and those where economic necessity and apparent spare capacity in Asia in particular has encouraged a more rapid transfer of production

Major risk issues emerging centre around a) ensuring resilience of a much less visible and harder to control supply chain and b) ensuring that quality controls throughout the supply chain, testing and contractual arrangements reflect less tightly controlled risk.

As an existing but accelerated trend, underwriters are very much aware of the increased risk potential in both areas, although a worryingly small proportion of buyer respondents had really analysed or communicated additional risk management requirements.

> *"We need to be very careful in considering developing markets, often in partnership with local providers. It is inevitably a more complex logistics chain, and creates real challenges in managing regulatory differences and people from new cultures"* **(Insurance Manager, Independent Manufacturing, £100m-£300m)**

2. **Increased product development and diversification into new & unfamiliar products / services / territories,** in a bid to maintain revenue through the downturn

The response of many surveyed firms (again around half of all manufacturers consulted) to a drop in demand has been to seek to expand into new product/ service areas or target

market segments where demand is thought to be potentially more robust, e.g. electronic component manufacturers moving into renewable energy markets; automotive suppliers shifting away from a troubled core business. Since product risk (i.e. the damage a defect can wreak) is inherently end-use driven, even subtle changes here can drastically alter the underlying risk an insurer takes on. For corporates, this creates a very specific duty of risk disclosure which many have not yet considered.

Similarly, even where companies remain focused on core manufacturing competencies, we have encountered numerous examples of a) increased rates of product innovation and b) extending pure 'product' provision into a wider service offering, both to support differentiation in a declining market. The former increases the risk of product failure, which is greater on new than old model products as any design bugs are ironed out. The latter can introduce a whole new category of professional indemnity risk associated with product assurances or support advice, which many manufacturers are not used to addressing or purchasing insurance coverage for.

Such examples can be extreme: one large business in a high risk technology product segment had doubled its rate of new product launches in 2009 whilst cutting manufacturing lead times by 75%. From a quality management perspective, twice as many new products in less than 25% of the development period causes significant additional strain and directly raises risk. Even where such changes are more subtle, they often move companies closer to the cutting edge of their industry's innovation curve where risk tends to concentrate.

> *"We are investigating a lot of new opportunities, particularly as regulations change. Of course there are greater risks - new segments, new locations and in dealing with both suppliers and customers with whom we're less familiar."* **(Group Financial Accountant, Independent Manufacturing, £100m-£300m)**

3. **Systemic supply chain disruption reducing resilience,** through widespread operational rationalisation

Given the complexity and inter-connected nature of most manufacturing supply chains today, the degree of disruption caused by business failure/ insolvency amongst suppliers in one part of an industry system across the remainder of that system is widespread.

Significant impacts arise not just from outright failure, but also broader rationalisation measures taken to maintain business viability across all stages of the product supply chain: headcount reductions, site closures, stock reduction, reduced customer batch/ order sizes, shorter lead times, efforts to improve sourcing efficiency etc.

All of this impacts risk, and particularly resilience to interruption across the supply chain from raw material to end product customer, creating a systemic disruption to previously established risk and loss profiles. In addition, product quality control infrastructures may also become more stretched.

Details are often confidential by nature, but **c.85%** of manufacturer respondents raised concern with changes of this nature impacting the risks they faced, either directly within their own business or via supplier and/ or customer relationships. Specific examples discussed included enforced single sourcing (in place of 2-3 previous suppliers); the elimination of buffer stock or any production overcapacity throughout the value chain; consolidated production and distribution centres increasing risk accumulation; rapid bringing on scale of new supply capacity etc.

Given the already notorious difficulty of business interruption underwriting judgements, and the increasing proportion of total property damage loss costs they represent (some senior underwriters interviewed for this work put this figure as high as 70%), myriad changes of this nature prompt a clear need to re-scrutinise supply chains across the segment as little assumed knowledge remains reliable.

This issue is also exacerbated by some significant increases in lead times for purchasing and receiving capital equipment from manufacturers who have themselves destocked (following a major loss event where production equipment needs to be replaced) and, from a UK perspective, an exchange rate risk within business interruption due to the weakness of sterling where much of the capital equipment might be sourced from within the Eurozone.

> *"There has definitely been a big impact all over the industry. There was a situation recently where a supplier of a key component went bankrupt. The company then refused to release the design and the tooling – it really made us realise our vulnerability to certain suppliers went far beyond what we'd previously realised."* **(Internal Audit Manager, Independent Manufacturing, £300m-£1bn)**

4. **Shake up has also routinely changed liability distribution**, with many forced to assume new and undisclosed additional liabilities

As competitive pressures prompt operational response measures, they can also give rise to new contractual stress, as both large customers and distressed suppliers can seek to renegotiate liability terms.

Over a quarter of manufacturing respondents believed that they have as a result of increased pressure been forced to accept more liability in current contract negotiations than under expiring contracts. In these cases, despite best efforts to impose standardised contracts and control liability creep, some additional liabilities were being assumed – in relation to design risk, product warranties, recall costs, consequential loss etc.

Critically, many respondents where this is the case did not consider themselves obliged to clarify any such change to liability insurers or undertake any additional proactive disclosure, and thus the new underlying exposure often remains undetected.

> *"We are routinely now receiving pressure from customers whereby they try to transfer what feels like unlimited liability for the entire project. It's getting much harder to negotiate."* **(Internal Audit Manager, Independent Manufacturing, £100m-£300m)**

Multiple recessionary risk changes – Case Studies

Case Study One (Electronics Manufacturer)

- Response to increase innovation & shorten product R&D cycle – total range re-launch in early 2010
- Consolidation of UK distribution & warehousing operations from six sites to one sole location
- Recession as prompt for expansion of existing headcount reduction programme
- Exiting value segment entirely to focus on mid and high end products
- Expanded manufacturing outsourcing to China, leaving only the most specialist assembly in UK
- Large scale expansion of independent retailer channel to reduce large retailer dependence.

Case Study Two (Materials Manufacturer)

- Dominant exposure to two hard-hit core markets (automotive and construction) caused company to enter new customer segments and increase speed of international diversification to protect revenue
- Activity diversification also extended into new product material areas and partially into providing a 'packaged' service offering, creating entirely new professional indemnity risk potential
- Greater international spread and decentralised divisional structure felt by management to exacerbate central risk management and information disclosure challenge
- Increased recent pressure from major customers to extend the scope and scale of product guarantees provided, causing increased liability potential.

Source: Mactavish

4.1.2 Sector Two – Construction

Certainly amongst the sectors hit hardest by the current recession, we again focused broadly on UK headquartered firms within the £50m to £5bn revenue range, and covering all key sub-segments: housebuilding, commercial property, civil engineering & public works as well as support service providers, material suppliers etc. The demand impact in the early part of 2009 in particular was brutal and well publicised, devastating not just construction firm revenues but impacting across the whole value chain. Public sector stimulus spending has picked up a relatively small proportion of the overall slack, whilst creating numerous operating challenges as companies race to take advantage.

Critical findings of the construction risk report include:

1. **Diversification of work mix, increased Joint Ventures and flight to public sector leaving many companies working in unfamiliar territory**

Over 60% of sector respondents discussed a material completed or underway move towards bidding for new types of work, often public sector or involving new Joint Ventures, in order to substitute other sources of demand. Even where changes to work type are minor, contract structures, liability arrangements and governance / specification regime all pose new and unfamiliar challenges to management.

Examples of more significant shifts into entirely new areas of required competency were also worryingly commonplace – leading to firms often bidding in new geographical areas and/ or for types of infrastructure work well outside of their traditional fields of expertise. This may create exposure to new risk types (e.g. asbestos exposure or the risks associated with working in derelict buildings are clearly much more prevalent in refurbishment and infrastructure work vs. new building). The challenge to control both contracts and practical risk management in this scenario is very much increased.

Whilst we are of course not questioning inherent construction sector competence, such factors clearly change the risks to which companies are exposed, and suggest that underwriters must analyse afresh both the mix of work firms undertake and the controls (both contractual and operational) in place to limit risk. Historic understanding of activities is a decreasingly reliable indicator of future risk.

Many respondents also believe a second round of company failures is likely as public sector funding runs dry before private sector recovery.

> *"Public sector work will simply not be the panacea: we have lost out from several projects being shelved, and it's a very different environment for us"* **(Risk & Insurance Manager, Construction, £100m-£300m)**
>
> *"Contractors are now routinely winning bids they're not qualified to do"* **(Group H&S Manager, Construction, £500m-£1bn)**

2. **Increased potential for previously excluded liabilities,** as contracts become less standardised, Joint Ventures more common and contractual terms come under increasing negotiation pressure

Almost all respondents recognised an increasing level of difficulty at an industry level in controlling contract terms under current conditions, in particular around liability capping. Negotiation between multiple desperate bidders and those controlling scarce budgets clearly increases the need to compromise and erodes the ability to institute standardised terms. A significant minority (c.30%) reported specific changes already instituted which have increased contractual risks undertaken.

Multiple recessionary risk changes – Case Studies

Case Study Three (Building Firm)

- Huge drop in revenue & profitability – newly loss making in 2008/9
- Rationalised operating regions with significantly reduced site supervision as managers cover 2-3 times more sites spread much more widely, including an unprecedented number of mothballed sites
- Cuts made to Health & Safety budgets and resources in place, further stretching control and oversight infrastructure
- Change in work focus away from new build to regeneration work – different operational requirements and local authority contract / governance structure altering risk exposure.

Case Study Four (Housing Developer)

- Collapse in speculative housing market prompted large scale redirection to social housing as well as headcount and cost reduction measures
- Adaptation requirement to new contracting framework and to manage increased lead developer liability potential: detailed fixed build specifications and far greater up front contractual definition as part of initial tender process
- Major disruption to established supply base to comply with public funding conditions creates new quality risk potential. Enforced move away from long-term supply relationships to social housing approved suppliers regardless of perceived cost/ quality comparison
- Specific concerns emerging around residual liability for defects given lower margin environment and severe competition driven cost pressure – increased need to scrutinise product sourcing for long-term quality implications.

Source: Mactavish

In addition, a number of sector respondents (c.35%) report an increasing tendency to engage in JV activity to increase the scope of viable bid work. This group included several firms that had historically maintained a clear policy to avoid such arrangements due to the difficulty of cultural alignment and risk/ liability sharing. The message in short was that concerns over such risks, though unchanged, are a luxury that cannot be currently indulged.

A significant proportion of respondents reported an expectation of increased liability disputes to emerge over the coming 12 months.

> *"There is already far less standardisation across our contract mix nowadays, as firms try to cap their liabilities and it gets harder and harder to negotiate"* **(Insurance & Risk Manager, Construction, £300m-£1bn)**

3. Intense cost cutting systemically increasing risk across the sector

General recessionary cost pressures have been extraordinarily pronounced amongst construction businesses, with significant aggregate funding impacts on areas such as health & safety risk management. Specific examples raised included sometimes drastic reductions in H&S headcount and budgets, and rationalisation of regional site management resource (e.g. redundancies expanding a single site supervisor's area of site responsibility five-fold). At least some knock on impact on site practice compliance and injury incidence must be expected.

Exacerbated by massive increase in competition for remaining work and increasingly common 'suicidal' bidding practices, with typical 10+ bidders per tender vs. 2-6 bidders 18 months ago:

- Objective to maintain cash flow rather than assure profitable work within core competence areas
- Less pre-qualification checks being undertaken
- Increasing importance of price as bid decision criteria, increasing likelihood of corner cutting and downstream liability disputes

Emergence of new recessionary risk exposures, such as large scale mothballing (one housebuilder consulted reported mothballing over half of all sites in 2009) increasing the need for site protection against vandalism/ arson / risk to public etc.

Although not likely an immediate issue, and not limited purely to construction firms, several buyers within this segment raised the issue of overtrading risk, as once growth does return to the segment the pressure on many much leaner organisations to rapidly scale up activities could stress risk management infrastructures even more.

> *"Staff are under pressure in branches, rushing around with less people, so at an industry level we can definitely conclude that Health & Safety risks have increased."* **(Company Secretary, Construction, £1bn-£5bn)**

4.1.3 Sector Three – Retail

Another hugely affected sector, practically all retail respondents (excepting those in counter-cyclical, low budget product categories, and those dominated by value food products) reported a damaging demand impact through 2008/9 as low economic confidence drastically curtailed consumer spending. The research's focus remained within the core £50m to £5bn revenue segment, and covered a wide selection of retail businesses: clothing; food; fuel; online/ catalogue specialists; generalist retail; low-budget and niche product specialists. Although a diverse set of findings in

terms of the range of change measures being undertaken, the degree of financial and operational strain identified amongst UK retailers was extremely pronounced, with significant risk changes occurring and being only gradually recognised.

Key themes emerging from the retail sector work include:

1. **Fundamental shifts markedly increasing retailer product risk exposure**

Retail segment traditionally relatively insulated from product risk (both damage claims arising from products sold and the cost of recall), given their ability to pass liability up the supply chain to product designers, manufacturers, distributors and even component suppliers.

However, nearly three quarters (74%) of retail respondents pointed to recent changes which have materially increased this risk:

- Increased direct retailer involvement in product design
- In some segments, growth of own brand retailer product share
- Increased need to re-negotiate supplier liability terms, shifting established liability divisions and requiring retailer vigilance
- Increased sourcing from low-cost country manufacturers where subrogation (passing on liability for the loss to the upstream manufacturer) is thought to be substantially difficult if not impossible (and contractual measures to manage such risk are often hard to enforce)
- Recognition of upstream cost pressures impacting the challenge of managing product quality risk in general (either through reduced quality control resource, suppliers sourcing cheaper raw materials or through the initial establishment of new, lower-cost manufacturing locations, or suppliers change their sub suppliers of components without notification).

Of those who raised having undertaken the measures above, only around half had previously recognised a direct impact on risk prior to specific consideration during this research consultation. The extent to which such changes to risk have been quantified or communicated to insurers is therefore very limited indeed.

The minority of retailers who were unconcerned by these developments tended to be focused purely on very low risk product categories.

> *"The mix of what we sell has changed dramatically... ...we are currently managing a very large product claim (>£10m), which came from a range of products deemed to be traditionally very low risk... ...We now source extensively from the Far East... ...we realise that there is simply no prospect of getting money out of them [specific Chinese suppliers]"* **(Insurance Director, Retail, £1bn-£5bn)**

2. **Significantly re-shaped product supply chains impacting retailer operational resilience**

Operational innovations by retailers, and their suppliers, to reduce working capital requirements and improve profitability have significant knock-on impacts on business interruption risk in particular.

Nearly 90% of retailers consulted pointed to important supply chain rationalisation measures having been instituted within the past two years, which have altered BI resilience. Common examples included the following:

- Consolidation of multiple distribution centres / warehousing operations into substantially fewer or even a single site, increasing risk aggregation and reducing redundancy
- Consolidation of supplier base driven by cost objectives, often without any specific consideration being given to business continuity drivers
- Increased and more stringent adoption of 'Just in Time' methods and often significantly reduced stock inventories throughout the supply chain since the inception of the recession (in some cases to less than 50% of pre-recession levels), again reducing resilience
- Reduced facility management resource, e.g. moving from dedicated facility managers at each warehouse (overseeing procedural, housekeeping and safety compliance) to as little as one per five warehouse sites.

> *"Since 2007 our business has experienced a lot of changes and we have many people new in their position who don't always have the experience to deal with what are often new risks. Our sales went down, we had to review our costs and decided to close 50% of our distribution capacity and reduce the numbers of suppliers by two thirds... ...at the same time we're moving more towards a JIT approach which we are aware is more risky, but is a necessary step in terms of cost efficiency"* **(Company Secretary, Retail, £300-£1bn)**

3. **Credit risk – reduced availability representing the critical near term risk for many retailers, with knock-on product quality & supply reliability concerns**

Massive credit insurance market contraction particularly pronounced in retail given a number of retailers surrendering to bankruptcy (although the issue is far from limited to this sector). 50% of retail respondents raised this point as a key concern.

Sudden withdrawal of credit insurance availability against a retailer highlights the dependence of many firms on what is a highly volatile form of working capital, which financial management may be unaware is even being purchased against them until they have to deal with the consequences of its withdrawal.

Retail examples raised included immediate demands from suppliers for up-front payment (or drastically reduced payment terms, e.g. from 90 to 15 days) for extremely significant sums (some into the tens of millions) to continue supply, adding further strain to already difficult cash flow conditions.

Multiple recessionary risk changes – Case Studies

Case Study Five (High Street Retailer)

- Severe revenue drop in 2009 led to closure of a substantial number of retail locations
- Project to review supply base resulting in >60% reduction in the number of suppliers used whilst identifying a number of new areas of single-source dependency
- Consolidation of multiple distribution centres to a single site, increasing risk accumulation as well as intended efficiency gains
- Growth in 'own branded' products sold combined with increased upstream product design involvement expand product liability scope – objective to triple to c.50% value share
- Rapid expansion of Far East product sourcing programme – previously unknown quality issues emerging and subrogation difficulty already experienced alongside cost savings

Case Study Six (Diversified, multi-channel retailer)

- Implemented ~£50m cost saving programme in 2009, including large scale redundancy programme and reduced opening & office working hours
- 25% reduction in total supplier numbers whilst expanding into many new relationships and geographic regions to secure additional cost advantages. New relationships increase both quality control and supply continuity challenge during ramp-up phase
- Additional complexity created by unprecedented speed of changes to product mix sold given altered consumer behaviour, exacerbated by reduced inventory throughout supply chain
- Significant product claim activity in relation to Chinese supplier and undisclosed upstream changes to manufacturing process, with expensive cost subrogation efforts unsuccessful
- Increased emerging technological concentration of risk given rapid online channel growth and greater systems reliance throughout business – creating new risk quantification challenges

Source: Mactavish

Companies are also being newly required to spend time and senior resource liaising with credit insurers to convince them to continue offering cover to their suppliers based on financial health. The most direct risk consequence is that such withdrawal can leave already vulnerable retailers unable to access a sufficiently wide base of suppliers with the highest quality suppliers opting to align with retailers in the best financial health (especially in troubled segments where competing retailers are all chasing a shrinking pool of viable potential suppliers). A significant minority (over 20%) of retail respondents were actively concerned at potential downstream impact on product quality due to limited supplier choice arising from a negative financial perception and credit insurance withdrawal.

> *"Last year no one wanted to work with us because it was impossible to buy credit insurance on our risk. As we were moving our supplier base to the Far East, we had to work with the few suppliers who agreed to sell to us – it's far from ideal".* **(Finance Director, Retail, £100-£300m)**

4.1.4 Sector Four – Financial Services

Financial Services is perhaps the most challenging sector of interest given its centrality to the emergence of the recession and the severity of the emerging regulatory shake-up. Our focus in this research was on mid-sized financial institutions. While this sample was naturally very diverse, a number of critical areas will be analysed in more detail in the subsequent sector report. For some financial services firms, a meaningful comparative measure of turnover was not immediately estimable and therefore interview extracts are attributed without a note of the turnover segment that they fall under.

Key themes emerging from the financial services study include the following:

1. **Risk guardians in Financial Services are less willing than those in the other sectors investigated to accept, once challenged, that the credit crunch and recession necessitate review of how operational risks are managed**

Mactavish's research has highlighted a number of emerging notifications and insurance claims that have affected many different financial institutions: breach of investment mandates; mis-selling of investment products; errors and omissions claims because of volatile markets exacerbating trading errors; losses relating to a lack of proper due diligence on Madoff, with claims being made under Fidelity, PI and D&O insurances; employee fraud increasing because of the recession; claims against funds for imposing 'gates' and preventing redemptions; mortgage and valuation fraud involving solicitors, banks and building societies; claims against banks for custodial issues and Stanford; misrepresentations concerning the pricing of Collateralized Debt Obligations; negligent investment advice; failure to discharge oversight/fiduciary responsibilities properly leading to D&O claims; vicarious liabilities for actions of outside service providers.

In addition to this changing insurable risk arena, the business environment is also undergoing wide-ranging environmental change – from the increasingly onerous regulatory obligations

imposed by the FSA to the virtual seizure of the 'shadow banking' system.

Mactavish would therefore expect companies in the sector to accept, once challenged, the need to routinely review the way operational risks are managed given this backdrop. However, compared with manufacturing, retail and construction, the acceptance for such review is not widespread.

Perhaps the most surprising finding is the prevailing view Mactavish encountered that business models were essentially robust and did not need to adjust in light of the credit crunch and recession. Some firms are making changes to how specific operational risks are managed, but the majority did not think that a review of operational risk management was warranted. Half of all respondents explicitly argued that their businesses were simple, 'vanilla' organisations and that exposures to low-frequency, high-severity risk were not significant – nor were these exposures changing because of the downturn.

This finding is particularly concerning as it suggests a naive or complacent attitude within the sector to managing operational risk, particularly when contrasted with other sectors. Further, a vocal minority of respondents clearly stood out from this position: they believed that far-reaching changes to operational risks were emerging (either new risks or simply developing a better understanding of established risks as losses emerge) and were highly critical of the endemic complacency suggested by this view.

This also chimes with a key thrust of emerging FSA stress-testing policy which lies in encouraging FS firms to take a more active and holistic approach to identifying unexpected risks to their business. The FSA have criticised a "collective failure of imagination" felt to historically characterise the sector's risk assessment approach.

Although as a result of this reluctance precise clarity over future changed strategies and operations in order to better manage operational risk was harder to establish, this naivety or complacency alone should be of concern to insurance underwriters as those consulted were specifically responsible for operational risk management and / or insurance disclosure.

> *"Risks aren't changing; there are just changes in profitability"* **(Finance Director, Asset Management, £50-£100m)**
>
> *"Our business isn't unduly affected by the recession because of our low-risk strategies"* **(Finance Director, Asset Management)**

2. There is a potentially damaging disconnect in perceived risks between financial services management and the underwriting community

There has been a marked shift in perception among underwriters of the risks faced by even relatively simple financial institutions and the interconnected complexity of how risks can spread throughout the sector.

While the majority of financial services respondents argued that their businesses remain fundamentally low-risk and straightforward, underwriters have reassessed the sector and it is one of few areas where the insurance market has already hardened somewhat. Insurance buyers in financial services therefore face a battle to counter external perception of risks within the sector and their businesses.

Overall, it is clear that most buyers have not yet made any real effort to communicate changes to operational risk at a granular level. Even where this effort has been undertaken, it has not yet been successful in allaying fears of increased risk exposures.

Expectations of new, large-scale claims issues in 2010 are commonplace among insurers. Hot topics include product mis-selling, valuation/ mortgage fraud, shareholder D&O lawsuits and emerging cyber-crime risks.

With external understanding of financial services products and operational details typically limited, this disconnect will eventually lead to insurance capital being both less easy to access and increasingly costly. This perception gap will not narrow unless buyers in financial services become more willing to articulate changes to business risk and risk management practices.

> "Buyers thinking that it's business as usual is extremely short-sighted – we're seeing already that it's not and there will be a lot more to come" **(Senior Financial Institutions Underwriter)**

3. A spotlight needs to be shined on poorly understood risk exposures in financial services, given expectations of significantly changing loss patterns

Insurable risk is not as high up the agenda of most mid-sized financial services management teams as are market risk, credit risk or regulatory compliance.

Many of those responsible for insurance consulted in this study profess to have limited understanding of exposures within key, potentially high-risk classes. In particular, respondents raised PI, D&O and cyber-liabilities (both the crime and business interruption aspects of online operations) as key areas of exposure concern. The most common, uncertain PI risks (e.g. around mis-selling, breach of investment mandates or unsuitable investment advice) were raised in half of all financial services sector buyer consultations.

Topics of increased underwriter interest vary by sub-sector but signify a real step-change in concern. To take an example, among building societies key priorities to address unease included explaining controls around valuation practices and arrears management in light of Treating Customers Fairly regulations set in place by the FSA. These changes represent a real and rapidly increasing risk; however, in most cases buyers have not yet addressed related disclosure.

Multiple recessionary risk changes – Case Studies

Case Study Seven (Building Society Segment)

- Impact of bailouts and extensive and imminent further consolidation expected
- Ratings agency downgrades
- Significantly increased regulatory oversight impacting compliance activities with further future clarification expected: Retail Distribution Review, Mortgage Market Review, arrears management / Treating Customers Fairly etc.
- Walker report governance and risk management implications
- Severely restricted access to wholesale markets
- Marked increase in competition for retail deposits
- Already public fraud losses with significant expectation of further incidents to come to light – e.g. around mortgage valuation, solicitors and potential mis-selling
- Implications of Profit Participating Deferred Shares giving holders a share of future profits – akin to 'semi-demutualisation'

Source: Mactavish

In addition, a minority of FS buyers speculated that in addition to the initial recessionary impact on e.g. fraud claims there would also be a secondary round of claims emerge (a 'fraud double bubble'), caused by both latent discovery of previous fraud and the impact of shifting regulatory goalposts. Although some of the expected new losses described are already emerging as (often well publicised) claims, given the 'long-tail' nature of the insurance classes involved there will be an extended lag before the full impact is known.

Research suggests a notable range of different potential claim types where the more forthright respondents have suggested an increase in underlying risk. This point is not just limited to the most high-profile media issues of mis-selling or mortgage fraud.

Despite a relaxed stance towards disclosure, over half of the buyers consulted in financial services were critical of insurer understanding of their operations and risks. As a result, the scope for buyer differentiation based on greater analysis and explanation of operational risk exposure and risk management is clearly high within the sector.

> *"Liabilities around structured products will be one of the next big battlegrounds"* **(Director of Operations, Investment Management)**
>
> *"The number of solicitors acting inappropriately or fraudulently has rocketed"* **(Operational Risk Manager, Building Society)**

4. **The regulatory burden being imposed on financial services firms is unprecedented in its scope**

Unsurprisingly, over half of all financial service respondents raised a major concern that the regulatory burden on their business (chiefly FSA compliance) had drastically increased during the past year, together with concern over potential retrospective application of rulings. This was particularly pronounced in the Building Society & financial advisory segments given the implications of such FSA initiatives as the Retail Distribution Review and Mortgage Market Review.

Interestingly, a number of respondents went further in suggesting that operational risk management efforts are being hindered in the short term by the huge diversion of resources to comply with a sharply increased regulatory burden.

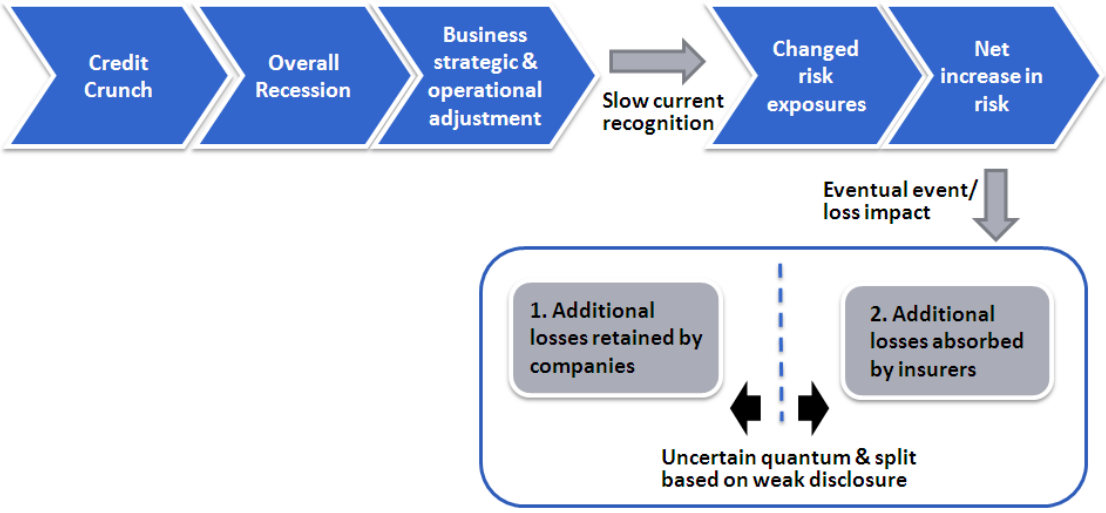
Regardless of how well directed measures prove in the long term, if operational controls are hindered whilst adaptation is ongoing (and as companies wait for FSA direction) it is a reasonable hypothesis that immediate risk will actually increase.

> *"We may have to pull out of certain business areas to in order to secure resource to be able to comply with regulations"* **(Operational Risk Manager, Financial Services)**
>
> *"I now spend nearly half of my time just dealing with FSA requirements. It is a huge burden"* **(Head of Compliance, Financial Services)**

4.2 Operational changes and insurance risk

Across the sectors under investigation, we have seen a wide array of significant strategic and operational changes being newly introduced – either as a direct response to perceived new challenges or as the trigger for previously considered measures to be brought forward and/ or amplified. Each of the sector reports which follow in this Mactavish series will examine the detail of, and evidence behind, these changes in more detail than we have above. However, what is clear is that we are presenting a strong case for material shifts in major high severity exposures, several of which cut across traditional 'insurance risk' classes, as well as the likelihood of a serious deterioration in the loss trends of more attritional classes.

Fig. 2 Increased risk as final, largely unrecognised, chapter of credit crunch



Source: Mactavish

Although insurers are already pointing to a nascent start of a spike in traditional 'recessionary' bogus or malice driven risks (e.g. low level employers' and public liability incidents), our focus is on the more volatile, lower frequency risks where a single unexpected large loss can individually be very significant for both corporate and insurer alike (operational resilience & business interruption; catastrophic product liability and professional indemnity protection; financial lines including crime, D&O, fraud etc.), and systemic risk deterioration. Such risks carry the dual challenge of a) relatively little historic loss data since major events are rare and b) huge dependence on company and circumstance specific details in order to assess risk and risk management sufficiency. As such, these areas are where weaknesses in the risk disclosure model are already felt most keenly, and where the challenge to communicate new operational changes to insurance capital providers is most thorny.

High severity risk is also where corporates have the most to gain by taking on this task – a disputed or delayed major claim arising from misunderstanding in such an area is likely to be material enough to represent a real threat to all but the largest corporate giants. At the same time, low loss frequency ensures that understanding of exposure changes emerges slowly, creating conditions for a punitive response where underwriters are surprised.

Clearly, the reality of businesses undertaking operational change is in itself neither new nor noteworthy. However, the critical finding from this work in 2009 is the sheer number, range and materiality of change measures that a majority of respondents are taking, and how concurrently they are taking them. This leads to both a clear uptick in the level of new and altered risks faced, and a likelihood that at least a proportion of measures will be unsuccessful, leading to a second round of disruption.

The report's core thesis is a simple one: changes to risk, and greater uncertainty over the transfer of new or altered risks where disclosure is weak, can be viewed as a natural consequence of business disruption resulting from the credit crunch and ensuring recession. This is shown in Fig 2 above.

Before coming to buyer and insurer responses, there are therefore two critical overall conclusions we seek to draw at this stage:

- **Significant material change is occurring to operating practices across all sectors, with the thrust of these shifts suggesting a higher level of underlying risk and a greater risk management challenge than during more benign economic times.**
- **This fact raises the disclosure burden on all parties in the insurance system, highlighting weaknesses in the traditional model and increasing the ultimate cost to companies of inadequate disclosure.**

5. Insurance buying response

5.1 Market conditions remain favourable, fostering complacency and a low current priority of insurance

From a buyer perspective, the study confirmed that insurance market conditions today remain broadly favourable (with recent renewal experience and forthcoming renewal expectations both typically in the flat to +10% range, with a few – encouraged by recent broker statements to this effect – still expecting further discounts at next renewal). Clearly there are a few isolated pockets where real difficulty has emerged. These pockets most notably include industrial credit insurance, areas of specialist PI (such as in relation to solicitors or surveyors) or isolated concern areas within Financial Services where a more severe rate impact has hit to date. Even within these more distressed pockets, although up to +100% like for like rate change has been reported in a few instances, a range of +10-20% is much more representative.

Broadly, the hard market which has been considered impending since 2008 has clearly not yet arrived in earnest, in the absence of any universal trigger or sudden change to capacity conditions as would have been the case had AIG collapsed as a major player, or was brought about with such effect by the Independent's fall and subsequently 9/11 at the start of the last hard market cycle. Likely as a result, this study has uncovered a relatively high level of buyer satisfaction with insurance suppliers (both incumbent insurers and brokers), very similar to the findings of Mactavish research in 2000/2001 before a significant change of heart by 2002/3 after market conditions shifted. If anything, recent market noise around rate hardening has frequently been attributed by buyers to expectations management by brokers seeking to gain additional credit for securing a favourable outcome:

> *"I believe that the market is talking itself up. Despite all the warnings I saw no hardening of the market at this renewal at all – there's plenty of capacity and competition out there."* **(Group Risk and Insurance Manager, Independent Manufacturing, £1bn-£5bn)**

Similarly, few moves have yet been made by most companies to evaluate increased deductibles or re-assess insurance coverage requirements in light of potential cost increases. Concern and interest in self-insurance has emerged in areas of the market where capacity has shown itself to be more limited (e.g. credit insurance, product recall within higher risk product categories) but these are very much the exceptions at this stage.

Perhaps more concerning, however, is the tendency for comfort with favourable market conditions to have led to a de-prioritising of insurance risk across the senior corporate agenda. After an apparent upswing in Board interest following the cost increases of the last hard market, Board involvement appears in many cases to have reverted to a cursory cost approval role.

> *"Directors sign off insurance, but they don't really know what they are signing. The Chairman just thinks everything we do is automatically covered simply because we have bought insurance"* **(Company Secretary, Independent Manufacturing, £300m-£1bn)**
>
> *"Insurance doesn't keep me from going to sleep at night. I just don't think it's that important"* **(Financial Director, Financial Services, £50m-£100m)**
>
> *"Insurance is just not as hot of an issue as it was, simply because the (premium) numbers are significantly down"* **(Financial Accountant, Independent Manufacturing, £100m-£300m)**

Given the degree of increased risk exposure emerging from current operational changes observed and its likely medium term impact on the cost and reliability of insurance cover, such complacency provides cause for concern. So, too, in light of our findings on disclosure adequacy should the resulting lack of willingness to invest additional time to address these limitations under current market conditions:

> *"I don't have the time or inclination to meet my insurers. It's not a high priority"* **(Financial Controller, Construction £100m-£300m)**
>
> *"Unless we can achieve a massive further reduction on our insurance premiums I don't necessarily want to spend any more time focusing on insurance."* **(Financial Controller, Independent Manufacturing, £100m-£300m)**

Insurance today remains viewed as, in effect, cheap capital by comparison with challenging debt and equity markets. However, it can be cogently argued that customers should view its importance in terms of the coverage limits provided, rather than premium spend at any given time. Focusing instead on cost alone suggests limited recognition of the role of insurance as contingent capital within the corporate finance mix, where the insurance industry overall has struggled to communicate its value.

5.2 Changes to the insurance buyer profile suggest limited hard market experience and, underwriters suggest, a decreasingly effective risk conduit

A somewhat unexpected finding of this survey – given relatively long traditional tenures in corporate risk management positions – was the high proportion of study respondents (c.60%) with current insurance decision making responsibility that did not hold this lead responsibility during the last hard market cycle. Thus part of any complacency finding may be a lack of direct hard market experience and a large scale shift in responsibility since the undoubtedly painful experience of insurance buyers between 2002-4.

That historic experience was characterised by severe cost increases (up to tenfold increases in cost were by no means unheard of in distressed segments such as food sector

property risk) and sudden insurance capacity limitations. The current tendency of many buyers to attribute favourable pricing to risk management improvements and shrewd purchasing behaviour that will successfully insulate their companies from potential volatility may prove short-sighted in what remains a cyclical market. If, as this research suggests is likely, eventual market hardening coincides with unexpected shifts in underlying loss patterns arising from operational change measures, underwriters are likely to be forced into reactive response mode.

A second observation on the current cadre of insurance buyers emerged more strongly from underwriter consultations, is the thesis that the changing nature of roles handling insurance buying responsibility increasingly represents an ineffective conduit for risk understanding. This point comprises two related accusations:

- First, that insurance buyers (often regardless of role) increasingly find themselves separated from operational detail across complex large businesses and may struggle to obtain sufficiently broad management support in respect of insurance placement

> *"It's always a problem for a Head Office team to understand the subsidiaries risks' and ensure the quality of data received is at the required standard. Insurance doesn't always have a high profile"* **Senior Liability Underwriter**
>
> *"Buyers can only declare what they know at the time which is increasingly challenging in this environment."* **Head of Liability Underwriting**

- Second, that an emerging trend towards professional purchasing function involvement in insurance decisions has reduced the level of both insurance knowledge and technical risk management specialism inherent in such decisions. This serves to increase the commoditisation of insurance whilst further limiting the standard of disclosure or risk management responsiveness achievable.

> *"We've seen the number of genuine Risk Managers reduced by ~50% in the last 6yrs which is a dramatic difference - this role is generally being replaced by procurement or other non-insurance people. It makes our job a lot harder."* **Head of Liability**

Although the sample of respondent roles with insurance responsibility in this study's significant sample (noted in section 2.2 above) did not suggest such a widespread delegation in full to purchasing departments has yet taken place, increasing influence of a purely cost focused (as opposed to coverage quality and reliability focused) purchasing mindset was in evidence in a significant minority of cases.

5.3 Scrutiny of insurance submission materials remains deeply insufficient

Regardless of the mix of roles responsible for insurance placement, a large majority (65% of corporate buyer respondents) have at most cursory involvement in preparing and reviewing insurance submission documents. This is despite formal risk disclosure material representing a *de facto* part of the legal contract of insurance coverage, against which subsequent claims will be assessed. Across the sectors under investigation, it is worth noting that manufacturing and retail buyers were by far the most likely to review such disclosure in detail (around half did), with FS and construction buyers typically much less likely to do so (only around a quarter).

Having presented this simple but quite startling analysis given the significance of such documentation in determining both premiums and major claim outcome, it is worth clarifying that a larger proportion of respondents were more concerned about this relative disengagement following this focused discussion of changing risk profiles faced and the potential risks surrounding disclosure. However, although encouraging exceptions were found, detailed submission scrutiny remains the exception rather than the rule. Further, the level of resource applied to compiling, verifying and improving the information used to explain companies' risks to underwriters has not noticeably increased in relation to recent operational changes.

Submission preparation remains for many companies a task largely conducted in relative isolation by the broker, with relatively little additional time investment to update and review documents year to year. Brokers themselves are operating under ever increasing fee pressure (with a number of examples uncovered of broker fees being well under half their level of 2-3 years ago), and buyers relying entirely on them to compile and explain all information necessary to fully understand business changes without explicit verification does appear to be something of a leap of faith.

This reality supports the thesis (which we return to below in section 6.3) that submission information routinely lacks detail important for underwriter assessments in order to obtain reliable coverage at the best terms and price. Most worrying still from a buyer perspective is the commonplace acceptance of a practice which must increase the likelihood of material error of the sort which could render a financially significant claim questionable. It would be unthinkable for buyers to accept such a high degree of relatively disengaged and under-scrutinised reliance on an external broker concerning the raising of any other form of corporate capital (debt or equity). This seems a reasonable point around which corporate shareholders might raise valid questions.

5.4 Scepticism remains prevalent as to insurer understanding of risk, with buyers largely unable to verify its adequacy or the resulting impact

Despite the apparent prevalence of such disengagement from the documentation, the past 5-10 years has seen significant innovation in the insurance buyer – broker – underwriter relationship, with substantially more face to face contact around renewal than was the case during prior Mactavish research on the disclosure process. However, unfortunately from both buyer and seller perspective this innovation in most cases is felt to miss the mark in terms of analysing risk, remaining focused on business courtesy and mainly constituting a preface to broker-led negotiations:

"I am sceptical that one meeting a year is sufficient to change the attitude of an insurer in the case of a major claim. A real impact could only be generated if the frequency of meetings is more regular and the relationship develops over a long period of time – that's not my experience." **(Company Secretary, Food and Beverage Manufacturing, £300m-£1bn)**

"An insurance buyer will get a better deal if he talks to the underwriter and if he gets the underwriter to meet the right people on the floor. It needs a lot more than what usually happens". **(Senior PDBI underwriter)**

Little scope exists for buyers to genuinely appraise or verify the adequacy of underwriter knowledge or gauge its impact on the offer made. As a result, buyers routinely adhere to the view that underwriters do not understand their business, and that the interface they experience with insurers often suggests a limited interest in doing so:

"The underwriters write the risk, senior executives run the business and client managers do their bit, but very rarely everyone pulls all this information together. As a team they don't understand our business." **(Vice President of Risk Management and Insurance, Independent Manufacturing, £1bn - £5bn)**

"Desired levels of underwriter engagement are light years away" **(Head of Risk Management, Financial Services)**

"Complex businesses can be difficult to understand from the outside without serious, extended engagement. There is change needed in the insurance world." **(Internal Audit, Construction, £300m - £1bn)**

An interesting buyer conflict begins to emerge here, between disengagement with submission materials yet frustration with perceived limitations in underwriter contact and knowledge. Further, despite limitations in the time available to underwriters to appraise each case many of them share the same frustration regarding limited access to management. Our conclusion, as initially arising from our 2002-3 research, remains that innovation in the compilation of risk information and the analytical elements of risk placement represents the only way to reconcile such seemingly contradictory findings.

5.5 Buyer concern around disclosure exists, but with limited priority and no consensus over how to address it

From a buyer perspective, the most common response to this mix of views is a resignation to powerlessness over how to address limitations in the placement process – they recognise weaknesses in understanding and the potential claim repudiation risk that can result, but are unsure of how to address them:

"It's all very well and good saying that we're covered but insurers will try to wriggle out on some technicality. There's a limit to what I can do to change that." **(Financial Director, Financial Services, £50m-£100m)**

Such resignation may in fact prompt a corporate response unhelpful to insurers. This research encountered a number of examples of companies responding to recognition of changes to their exposure arising from new operational measures not by addressing disclosure and looking to ensure common understanding, but instead by reviewing wordings in great detail to satisfy themselves that the altered risk would be covered without additional discussion. A naturally adversarial stance, such a response guarantees that the underwriting impact of such changes is felt only once changed claims patterns emerge in earnest, ensuring delayed but increased volatility across the market:

"Whenever things change as they are doing, my first response is to know what our policies actually cover given the changes in our operations. Over the years so many addenda have been added to our policies that they are a bit of a dog's dinner" **(Insurance Manager, Financial Services)**

Although, in general, a more positive reading can be placed on the finding of buyers in significant numbers recognising the need and scope to improve risk disclosure, even if they are often unsure how to go about it. Further, several have taken it upon themselves to attempt such innovation themselves, most commonly in areas of FS where tightening market conditions have impacted first. Examples included:

- Invitation of underwriters to bi-annual Board meetings to discuss key risks with the whole senior team. This strategy secured the dual objective of a) increasing the profile of insurance within the business and b) ensuring engagement of the most senior and capable insurer personnel
- Significantly increasing the volume and depth of information disclosed – some buyers have done so, typically looking to the broker for guidance, but too often representing something of a 'data dump' that may be unlikely to secure an optimal underwriting response

"We have taken a drastically different approach this year and have disclosed three or four times more information... It's easier to just give them everything" **(Operations Director, Financial Services, £50m-£100m)**

Certainly the more common response was recognition of the limitations in the current system but uncertainty over how to address it. Further, with insurance market conditions favourable and other operational and financial concerns typically more pressing, addressing such a thorny issue remains far from high priority.

For almost every corporate respondent, the process of recognising the risk profile impacts and linking through to re-considering both internal risk management and external risk transfer requirements remains either early stage or non-existent. As of end 2009, addressing these underlying changes and managing the impact on insurance programmes remains tomorrow's problem, instituting operational change in order to survive understandably retains front and centre position.

5.6 Neglecting risk disclosure carries significant risk

The UK legal framework around disclosure in corporate insurance claims today remains, in the eyes of many legal commentators, somewhat weighted in favour of the insurer, even if it is overdue further review as part of the Law Commission's ongoing review of insurance contract reform. In particular, the burden of proof around material non-disclosure as grounds for claim avoidance (based in large part on the landmark Pine Top ruling[10]) requires only that (a) the facts concerned would have had an effect (and not necessarily a decisive one) on the assessment of 'a prudent underwriter' and (b) the specific underwriter concerned can prove that the contract would not have been entered into on the same terms had the relevant facts been disclosed. Based on first principles, neither is overly demanding. Further, where (as is commonly the case) a proposal form includes a specific buyer warranty of information accuracy even this second condition may be unnecessary[11].

The Law Commission's consultation paper[12] on this subject makes this point clearly, and draws upon corporate evidence from its own research (including the quotes immediately below) to suggest many companies are unaware of the requirements placed on them by law. It also notes that the primary goal of immediate reform remains personal lines insurance, so the picture for large businesses is unlikely to change imminently.

> *"There is little doubt that the current arrangements for insurance law are often little understood, even by relatively informed buyers of insurance, resulting in unexpected, unfair and unjust outcomes – more so with some insurers than others"* **(Construction Industry Council)**
>
> *"While as a team we are of course aware of the principles of the law regarding disclosure, misrepresentation and warranties, we perhaps had not appreciated the full extent of the burden the law imposes on the purchaser of insurance"* **(Network Rail)**

Buyers should also be wary that rising losses and a hardening insurance market is also likely to coincide (as has been the case in the past) with strengthening insurer attitudes towards claims assessment. Presenting direct recent dispute evidence is difficult due to typically high levels of confidentiality and the fact that evidence of claims disputes infrequently reaches the public domain and only then after many years' delay. A majority are resolved through direct negotiation or at either mediation or arbitration stage, and in many respects a bigger part of the risk to insurance buyers in practice lying in payment delay and quantum reduction rather than pure repudiation.

Nonetheless, this research programme suggests there is enough evidence to imply that disclosure detail adequacy, and the policy wording specifics that result from it, can be a key determinant of outcome. Material examples included:

- Construction claims in relation to the indirect business interruption arising from faulty sub-contracted commercial building work, where coverage or otherwise was based around assessing underwriting intention and disclosure around the nature of works undertaken
- Product liability examples where specific product types or in particular product end-uses were not explained and held to represent material non disclosure and used to contest coverage
- Professional indemnity examples where lack of detail around activities undertaken were again held to represent material non disclosure and refute claim coverage
- Various examples across lines of risk where poor mutual understanding of specific underlying risk resulted in coverage wording that was too vague to enable meaningful quantification of loss, such that no claim could be raised at all.

It is clear that poor disclosure in the long-term is likely to increase the risk of claim repudiation or delay, and also that a sufficiently large portion of a major loss's total impact on a business remain uninsured so as to make avoidance through risk management in any case infinitely preferable to a successful claim in most circumstances.

Overall, benign current insurance market conditions present buyers with a 'limited time only' opportunity to prepare for more testing market conditions, and to limit their exposure to subsequent volatility of pricing and coverage availability. This opportunity should not be spurned. However, too small a proportion today appear to recognise the immediacy of this need to prioritise analysis and communication of changing risks and associated risk management practices, to position themselves to ride out the storm that is unquestionably starting to brew.

6. Insurance supply response

6.1 Suppliers concur that market conditions are likely to remain relatively benign in the short term

Similarly to buyer experience and sentiment, underwriter consensus expectations for upcoming renewals predominantly fall within the 0-10% range of price increases, with widespread recognition of fierce current price competition in both broker fees and insurance premiums. That said, a small minority of underwriters continue to hope for a stronger hardening market response to emerge before end 2010.

Whilst not a major focus of this study, this compatibility of expectations suggests that in the continued absence of a major trigger event significant insurance cost increases in the near term are unlikely. This remains true despite widespread acceptance of the reinsurer led commentary concerning the long-term need to raise rates from the current level to combat both a testing investment climate and forecast increases to property & casualty loss ratios even before accounting for any of the change identified in this report. This research clearly reinforces this expectation.

Exceptions focused on the coverage areas already detailed above (and in particular FS sub-segments where high profile exposure uncertainty has tended to foster risk aversion), as well as specific cases cited by underwriters where individual recent high frequency claims records required re-assessment.

6.2 Recognition of the materiality of current shifts to the risk landscape, and resulting increasing potential for claims acrimony and coverage misunderstanding

The critical focus of underwriter consultations conducted as part of this study was on verifying the materiality of operational changes observed and the likely long term impact on claims. Without re-compiling a full matrix analysis of each sector issue and each line of insurance risk, the thrust of underwriting response received combined the following factors:

- Agreement with the materiality of potential loss impact of the key observations noted above
- Generally a low level of existing awareness of such changes, certainly in insufficient detail in most cases to begin to quantify the underwriting response or assess company risk management adequacy in advance of claims emergence
- Concern at the increased potential for claims acrimony that they believe will result from a lack of detailed knowledge of changes arising case by case.

To give a flavour of this reaction, a sample of representative responses are set out below:

6.2.1 Importance of risk changes observed

"The huge increase in the risk of suppliers going bust has had a massive impact on UK companies' risks" **(Senior PDBI underwriter)**

"I need to know exactly where and who the insured is sourcing from ... while there are checks and controls in these new locations, they often won't be as high as is first thought and I've heard some horror stories.... if I can't be totally confident the insured can transfer liability onto suppliers I will price this into the risk" **(Senior Casualty underwriter)**

"Manufacturing and retail risk has been drastically increased by the increasing complexity of supply chains" **(Head of PDBI)**

"Retailers' product liability is changing dramatically... often because the manufacturer is in the Far East, subrogation is impossible." **(Senior Product Manager)**

"We have had a lot more issues recently which come down to workmanship and standards" **(Head of CAR)**

"Contractual liability just frightens me at the moment." **(Head of CAR)**

"If sites are being mothballed we'd be lucky to find out. It depends on the integrity of the broker and client to pass on that information" **(Senior CAR underwriter)**

"We have seen such a huge amount of notifications and pretty much paid claims coming out of the mortgage fraud area. It will clearly get worse before it gets better" **(Senior Underwriter, Financial Institutions)**

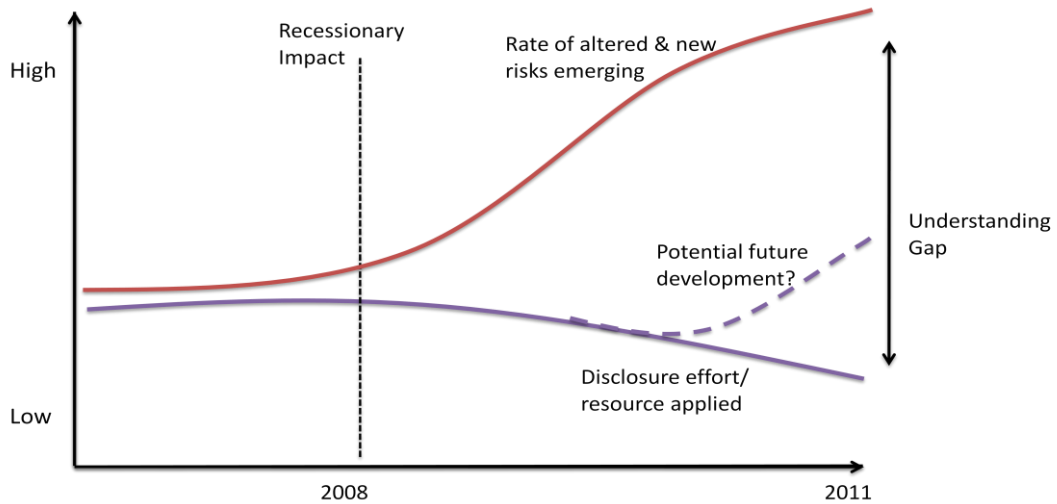
6.2.2 Awareness and disclosure/ acrimony potential

"Information about new products or services should absolutely be in the broker presentation, but generally we do not get that level of detail. That is a problem." **(Head of Casualty)**

*"We just do not tend to get the level of details required to understand the BI element of supply chain risks."***(Senior PDBI manager)**

"Supply chains are increasingly complex, and insurance arrangements are usually spread between different insurers which can significantly delay payments for the duration of negotiations... the lead insurer needs to build a strong case to be able to convince the co insurers to pay the claim". **(Senior PDBI underwriter)**

Fig. 3 Need to address growing risk understanding gap



Source: Mactavish

6.3 Fundamental flaws remain in the traditional underwriting model, with disclosure standards worsening

Underwriter analysis also confirms the view that despite the materiality of current shifts reshaping the corporate risk landscape, disclosure standards have not improved and the fundamental weaknesses of insurance disclosure remain substantially unchanged.

Section 5 has already considered points around the buyer attention applied to submission creation and review and the limitations in detailed underwriter access to operational management across companies whose risks they are seeking to assess. In addition, strong underwriter criticism was recorded in relation to the quality of formal submission information contained and the lack of ability to obtain additional detail from the broker, in particular around low frequency loss types where there is little or no indicative claims data:

> *"The standards of presentation are worse than ever... often the data provided is not checked and brokers will refer the underwriter to the company's website to present the company's operations... In particular, BI numbers are very rarely properly disclosed, which could become a massive issue for insurance buyers in a hardening market".* **(Head of PDBI)**
>
> *"Quality of submissions is not really improving. The broker thinks if they send 25 documents on email, that's good. It's like a data dump with random spreadsheets... The placing brokers are too busy to answer questions; they just go for the line of least resistance... I am surprised that customers think their brokers know the risks well and present them properly... Sometimes we literally get given the business description and the turnover and we are lucky if we get anything else."* **(Head of Casualty)**

However, access and disclosure limitations *per se* are not the only limiting factors preventing underwriters from grasping the challenge of case specific, forward looking underwriting judgements in respect of changed risks. There are also critical structural factors also at play.

The insurance underwriting world remains organised first and foremost around risk silos and areas of underwriting specialism, rather than around operational or sector led expertise. Whilst highly efficient in managing case load and the broker-underwriter interface (and thus keeping down transaction expense costs), a secondary impact is to dilute sector knowledge and limit individual underwriter exposure to operational management. This further limits appreciation of cutting edge sector specialist knowledge, where current operational change is rooted. Again, this necessitates awaiting claims led evidence of change suspected as a result of piecemeal evidence, rather than enabling a more certain assessment of likely impacts before they emerge.

Customers should, and increasingly do, recognise that underwriting innovation has been significant over the past 10 years, with a far more scientific approach taken to analysing historic loss patterns, modelling exposures and structuring underwriting assessment models in a way that creates a more consistent appraisal. However, the predominant thrust in this development has been to add structure to the assessment of the core set of underwriting information and to adopt portfolio level techniques to manage aggregate exposure. In essence, in doing so carriers are seeking to cope with the limitations in case specific information typically received on complex companies they assess. Given the need to align customer, broker and insurer behind a wider objective, much less progress has been made in finding ways to address and eliminate these same limitations, which would begin to erode the understanding gap and enable sophisticated new paths of underwriting development to take shape.

6.4 Resulting underwriter assumptions and enforced reactivity both increase volatility

If both the rate of operational change, and the likely level of underlying low frequency risk have both increased yet the ability for underwriters to understand such impacts in advance of losses emerging has not, then the key question for buyers becomes what will be insurers' response in the meantime.

Broadly, underwriter responses to this research suggest two parts to this answer:

- First, there is evidence to suggest a number of worst case assumptions in complex risk assessment areas are necessarily taken in the absence of fuller information – the lack of information thus punishing companies with better managed risks:

> *"I do wonder about the quality of data we receive on proposal forms. I just hope the premium we are charging will make up for some of these gaps."* **(Head of Casualty)**
>
> *"When writing product liability risk (for retailers sourcing from the Far East), I will have to apply the (much higher) rating of a manufacturer to the whole retailer where I feel they might be exposed to some manufacturing liabilities".* **(Senior Casualty underwriter)**

- Second, the dominant underwriting response was one of resignation simply to wait for claims to emerge, in the absence of information on which to base proactive judgements:

> *"It's definitely claims led... we'll have to see how this develops over time. There's a lot of noise and notifications – in some areas there probably won't be too much adverse development, in others there will be."* **(Senior Financial Institutions underwriter)**
>
> *"There is just a lot of information about the insured that underwriters will never hear about until the claim comes through."* **(Head of Casualty)**

Clearly, both elements of this response to information limitations ultimately serve to encourage a more indiscriminate, and more volatile, underwriting response. The result is blanket rather than specific judgements and the emergence of policy response to new risk developments only once losses have already been substantially incurred.

6.5 Conditions set for increased volatility and emergence of capacity 'blackspots' within focus sectors by 2011, despite pockets of real underwriter engagement

Despite an encouraging level of dialogue and engagement from senior underwriters with the key operational findings of this study, then, we conclude that fundamental limitations in the disclosure and the underwriting model remain. Combined with an increased level of risk associated with both changed operations and new emerging risk types these are likely to drive significant increased volatility as loss patterns begin to shift.

Underwriters' first response to changed loss patterns will, as ever, be to protect themselves through wording, pricing and capacity decisions aimed at recouping losses and avoiding the perceived highest risk exposures. Any subsequent product and coverage innovations to better align with emerging risks is likely to lag as very much a secondary response. This is especially true in today's risk-averse environment where insurers must broadly live without investment returns and following a sustained period of low insurance pricing.

Further, the more severe and sudden is the emergence of new or altered losses, the more severe and broad is likely to be the rational underwriting response. It is also inevitable that without much more granular risk information to isolate and quantify difficult new low frequency risks, such responses necessarily resemble sector based carpet bombing more than precise laser targeting. Partly rooted in the very principle of risk pooling on which insurance is founded, this effect is damagingly amplified by a low standard of disclosure. Although based on the above findings many buyers' memories appear to be fading, even the most recent insurance hard market so accentuated following 9/11 demonstrated this fact amply with vociferous buyer complaints around 'unnecessary' and 'knee-jerk' responses as capacity was decimated across areas of underwriter concern.

We contend therefore that inaction on disclosure and limitations in the fundamental risk placement and underwriting model will both work to create a coming insurance 'hard market' far more uneven and frequently painful than would be achievable were the capacity and will sufficiently available across all parties to fundamentally re-communicate and re-assess changing corporate risks. Further, the longer market hardening continues to be delayed through a generally benign traditional catastrophe claims environment and robust insurer competition, the more current underlying economic changes will already be reflected in altered claims patterns by the time 'normal' hard market conditions arrive. As a result, correspondingly greater booked losses will have already taken place, for which subsequent price increases will need to compensate, further increasing volatility. This sets the scene for a perfect storm of negative market conditions to emerge by 2011/12.

Again, the last hard market is instructive here – as by far the most extreme volatility was created in the food sector where the simultaneous double trigger effect emerged due to both a) constrained insurer capacity and market-wide rate increases and b) specific new exposure concerns around composite panelling insulation. It is also likely that had AIG not been rescued in 2008, not only would the hard market have already arrived but that its consequences, at least for those who were not AIG customers, would have proved less volatile than the conditions now likely to emerge.

6.6 Limitations create real scope for insurance provider differentiation in the current environment, and likely to prove a key determinant of ultimate shake-out

Finally, this research also suggests that opportunity exists for insurance providers to differentiate themselves by assisting aligned customers in responding to the disclosure challenge created by an unprecedented rate of change. The degree of recognition of this challenge amongst corporate buyers in this study, yet prevalent inaction, suggests a key and immediate competitive differentiator. This opportunity lies in both the technical analysis of changed risk and also related new product and service developments in response to the increased disclosure need and new risk types.

It seems likely therefore that both brokers and insurers who take the lead in both areas will be placed in an ever more advantageous competitive position during 2010 as awareness of the impact of such changes filters through the insurance world and wider economy.

Despite resource limitations and continuing pressure on fees, we would expect brokers to differ significantly in their ability to both flag this challenge to buyers not currently feeling great insurance related pressure, and to help those buyers through the difficult challenge of gathering, structuring and disseminating better risk information before such pressure emerges in earnest. Continuing to encourage a somewhat 'head in sand' approach for as long as the premium going remains good increases the likelihood of significant future dissatisfaction, likely causing increased broker switching once the market does turn.

Taking the lead on disclosure in 2010 is also likely to best position insurers to better select individual clients and protect themselves against emerging risks whilst also taking maximum advantage of the eventual upturn in market rates when it arrives. It also seems highly unlikely that the UK economy is in any danger of a rapid return to what was business as usual, and that many of the shifts described above will both prove enduring and give rise to a secondary round of adjustment in many cases. Thus being able to respond more rapidly with targeted changes to underwriting appetite and pricing based on specific risk knowledge becomes an attractive alternative to relying solely on broad-brush, reactive capacity withdrawal. Insurance providers best able to adapt to this environment are likely to reap ongoing benefits.

Although the large composite insurers (aside from the obvious special case of AIG) have thus far come through the financial crisis relatively unscathed, it is clear that both the extent of exposure, and appropriateness of response, to what are significant changes to corporate risk profiles should drive significant performance differences between insurers. This will be reflected in the loss ratios, reserves adequacy and ultimately earnings performance of those heavily involved in corporate segment property & casualty risk. Composite insurers with a range of other activities (most obviously SME focused, personal lines and life insurance) may perhaps be diversified and well capitalised enough for this not to imminently threaten failure, but it is a sufficiently material issue to prompt real concern. And it is worth noting the presence of six insurers and reinsurers, of whom at least four have a significant exposure to this segment, on the list of the 30 most systematically important institutions recently highlighted for attention by the Financial Stability Board[1]

7. Conclusion

The findings above, for the sectors under investigation, set out a clear conclusion of a **markedly increased rate of corporate change arising from recessionary pressures, and a firm conclusion that the net impact is to raise underlying risk.** This arises from both increasingly complex and inter-connected industry value chains and the concurrence of operational change measures arising from unprecedentedly difficult trading conditions.

In general terms, our central observation is not a positive one: **these changes have not yet been reflected in the assessment or communication of risk**, **putting coverage at risk.** Ultimate likely loss impacts are certain to take between one and three years to fully filter through to gradually evolving underwriting assessments. Further, unchanged disclosure system weaknesses, a somewhat complacent demand side and an often frustrated underwriting community resigned to wait for impending losses all suggest eventual volatility. The only apparent certainty is that altered risk patterns are arriving faster than at any time in recent memory but in no clearer focus.

Arising from this core argument are important consequences for both buyers and sellers of insurance. For buyers, there appears to be a **one-off opportunity to prepare in advance to insulate against subsequent volatility in the cost of risk** (both direct and indirect) through careful investment in better explaining areas where risk has moved on. In addition, they must seek to work with underwriters to understand and allay unjustified fears whilst agreeing any required changes to risk management priorities arising.

For no party in the current insurance transaction model, however, is this an easy challenge. By definition, it requires alignment of customer, broker and insurer to improve risk insights in the absence of an immediate commercial pressure to do so. It also necessitates moving beyond traditional risk assessment and submission/ proposal form pro-formas into uncharted analytical territory. Successfully doing this will require unprecedented engagement from operational management alongside risk managers, and at the same time need to overcome intense competition for underwriter attention and time within often significantly streamlined and resource constrained insurer organisations. As of end 2009, those seeking to firmly grasp this nettle from either demand or supply side remain firmly in the minority, working within a system that is today structurally ill adapted to support and reward such individual efforts.

So if we are additionally resigned to conclude that, on the whole, neither current disclosure standards nor the predominant attitude amongst either buyers or sellers of insurers is consistent with addressing such an undeniably stiff challenge on a large scale, we must conclude that significant volatility will result. Even if it takes more than the full course of 2010 to play out we can expect an uneven and brutal hard market cycle to eventually emerge. **Conditions could align towards a 'perfect storm' of insurance capital volatility** if delayed hard market onset both follows a lengthy period of severe insurer price competition and coincides with major new loss pattern emergence.

However, the evidence also suggests more specific areas where questions should be asked of both insurer and corporate management:

- First, that additional shareholder scrutiny of changing corporate risk profiles, increased risk potential, and the certainty with which risks are today being reliably transferred is very well justified
- Second, whether the current approach of many buyers is ultimately a significant contributory factor to exactly the indiscriminate insurer response so damaging and extensively criticised in previous hard markets. Without better information more measured and precisely targeted insurer policy changes are impossible and similar volatility is likely to ensue as loss patterns change
- Third, it seems likely that, in light of the volume and negative thrust of operational risk changes being seen, uncertainty and a widespread lack of underwriting detail is driving systemic insurer risk under-pricing that has not yet really begun to come to light. This is especially concerning in light of depressed insurance rates and the ongoing intense price competition which characterises today's corporate insurance market.
- Fourth, given a range of high profile failures of financial institutions to fully understand risks assumed in the past, can a parallel be drawn with property and casualty insurers involved in business insurance risk today, where all parties suggest understanding of complex and changing individual exposures is increasingly insufficient. While the full loss impacts arising from such changes will inevitably take years to fully emerge, this suggests eventual volatility is likely and that performance differences should be expected between insurers in how they are able to cope with the challenges set out.

Overall, as a research activity, the primary outcome of this report has been to set out an overall picture of a materially increased and changed risk landscape and a limited level of readiness demonstrated thus far from all parties to respond to the challenge this represents. This paper points to a number of critical questions arising from this core finding, but also suggests that further debate can and should be undertaken as to both investor and management implications and responses over the coming months. Ongoing Mactavish research throughout 2010 will aim not only to analyse sector detail but also to explore the effectiveness with which each party picks up this emerging challenge.

8. Ongoing research overview

As explained above, this paper sets out the initial emerging cross-sector themes as part of a much wider ongoing programme of research. This will continue throughout 2010, considering additional industry segments and also tracking how the most key overall themes noted above continue to play out. In particular, we will focus on the emerging responses of both corporate guardians of risk and the insurers and brokers who provide services to them.

Further published findings will combine both segment issue specific papers analysing operational and risk impacts in greater detail, as well as thematic follow-up in 2010 analysing the consequences of the changes noted and both buyer and seller response patterns.

Following completion of initial exploratory investigations in 2009, the full research programme will also extend into France and Germany during early 2010.

Endnotes/ external sources:

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6. *Experian UK Insolvency & Distress Index, September 2009*
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11. *c.f. Unipac (Scotland) Ltd. v Aegon Insurance Company (UK) Ltd. [1999] 1 Lloyd's Rep. IR 502*
12. *Law Commission, Reforming Insurance Contract Law – A Summary of Responses to Consultation, October 2008*
13. *Financial Times, 30 November 2009*